

2000

Investment companies industry developments, 2000/01; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Division, "Investment companies industry developments, 2000/01; Audit risk alerts" (2000). *Industry Developments and Alerts*. 215.
https://egrove.olemiss.edu/aicpa_indev/215

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Investment Companies Industry Developments— 2000/01

Complement to AICPA Audit
and Accounting Guide *Audits
of Investment Companies*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

The AICPA staff wishes to thank Robert C. Fabio, Brian J. Gallagher, Steven D. Krichmar, Wm. David Seymour, and Matthew J. Tomasicchio for their assistance and contributions to this Audit Risk Alert.

Maryann Kasica, CPA
Technical Manager
Accounting and Auditing Publications

*Copyright © 2000 by
American Institute of Certified Public Accountants, Inc.,
New York, NY 10036-8775*

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please call the AICPA Copyright Permissions Hotline at 201-938-3245. A Permissions Request Form for emailing requests is available at www.aicpa.org by clicking on the copyright notice on any page. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

1 2 3 4 5 6 7 8 9 0 AAG 0 9 8 7 6 5 4 3 2 1 0

In This Year's Alert...

Economic and Industry Developments

- *What are the industry and economic conditions facing investment companies in the current year? Page 7*

Regulatory Developments

- *What are some of the final rules issued during the past year by the SEC that auditors of investment companies should be aware of? Page 14*
- *What are the significant issues raised in the most recent "Dear CFO" letter? Page 24*

Audit Issues and Developments

- *What are some of the highlights of the new AICPA Audit and Accounting Guide Audits of Investment Companies? Page 28*
- *What guidance is available for auditing derivative instruments? Page 30*
- *What are some of the audit considerations in an e-business environment? Page 33*
- *What are the requirements of the ISB's Standard No. 2, Certain Independence Implications of Audits of Mutual Funds and Related Entities? Page 36*
- *What is money laundering? Page 37*
- *What are the responsibilities of predecessor and successor auditors under SAS No. 84? Page 40*

New Auditing and Attestation Pronouncements

- *What are the AICPA's new Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Audit Interpretations that auditors of investment companies should know about? Page 44*

Accounting Issues and Developments

- *What are the requirements of the new FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities? Page 53*
- *What are some of the recent developments affecting the accounting for derivatives and hedging activities? Page 55*
- *What are some of the recent SEC accounting-related developments? Page 58*

On the Horizon

- *What are some of the outstanding exposure drafts that have been issued by the FASB for comment? Page 60*
- *What are some of the outstanding exposure drafts relevant to investment companies that have been issued by AcSEC for comment? Page 62*
- *What exposure draft has been issued by the ASB for comment? Page 62*

Resource Central

- *What other AICPA publications, products, and services can be of value to auditors of investment companies? Page 63*

Table of Contents

INVESTMENT COMPANIES INDUSTRY DEVELOPMENTS—2000/01.....	7
Economic and Industry Developments	7
Competitive Environment.....	9
Merger Activity	11
Decimalization	13
Regulatory Developments.....	14
SEC Regulations	14
SEC—Auditor Independence Requirements	21
Other Recent SEC Developments	21
SEC Annual “Dear CFO” Letter	24
Audit Issues and Developments	28
New AICPA Audit and Accounting Guide, <i>Audits of</i> <i>Investment Companies</i>	28
Auditing Derivatives.....	30
E-Business	33
ISB Standard No. 2, <i>Certain Independence Implications</i> <i>of Audits of Mutual Funds and Related Entities</i>	36
Money Laundering Activities.....	37
A Change of Auditors.....	40
Impact of New Accounting Pronouncements	42
PITF Practice Alerts	43
New Auditing and Attestation Pronouncements	44
Auditing Standards.....	44
Auditing Interpretations	49
New Attestation Standard.....	51
Accounting Issues and Developments	53
Transfers and Servicing of Financial Assets and Extinguishments of Liabilities	53
Derivatives and Hedging Activities	55

Other New FASB Pronouncements	57
SEC Accounting Issues and Developments.....	58
On the Horizon	60
FASB Exposure Drafts.....	60
AcSEC Exposure Drafts	62
ASB Exposure Drafts.....	62
Resource Central	63
Order Department (Member Satisfaction).....	63
Continuing Professional Education Courses.....	63
Accounting and Auditing Technical Hotline.....	63
Ethics Hotline	64
Technical Practice Aids.....	64
AICPA <i>reSOURCE</i>	64
Assurance Services Alerts	64
References for Additional Guidance.....	65
APPENDIX A—FEDERAL REGULATIONS RELATED TO MONEY	
LAUNDERING	67
APPENDIX B—AICPA INDUSTRY EXPERT PANEL CREATED	69

Investment Companies Industry Developments—2000/01

Economic and Industry Developments

What are the industry and economic conditions facing investment companies in the current year?

The growth in the U.S. economy in recent years continued through the end of 1999 and into 2000, fueled in part by increased workforce productivity and consumer spending. In February 2000, the current period of economic expansion became the longest in history, at 107 months. Among the economic statistics and other developments through the first three quarters of 2000 are the following:

- The equities markets continued to display periods of volatility. Both the Dow Jones Industrial Average (DJIA) and the National Association of Securities Dealers Automated Quotation (NASDAQ) composite ended 1999 at record highs, nearly 11,500 for the DJIA and over 4,000 for the NASDAQ. By March 2000, the NASDAQ reached a new milestone, closing at over 5,000 for the first time. After reaching these milestones, however, both the DJIA and the NASDAQ experienced steep declines from their record highs, as well as periodic gains back toward these earlier milestones.
- The much-anticipated Year 2000 Issue, with its potential for negative economic implications, has so far passed without any major impact.
- Gross domestic product (GDP), which measures the output of goods and services produced by labor and property located in the United States—increased at a rate of 4.8 percent in the first quarter of 2000. GDP then rose to 5.6 percent in the second quarter. Third quarter GDP estimates, however, have indicated a rate of less than 3 percent.

-
-
- The euro has weakened significantly against the U.S. dollar.
 - The U.S. jobless rate remained under 4.5 percent, reaching a thirty-year low of 3.9 percent in April and September.
 - The Federal Reserve Board (Fed) raised the federal funds rate three times so far during 2000, to 6.5 percent.

Auditors should review the guidance in Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). The auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions, as they relate to the specific audit.

Keep in mind that this section of this Audit Risk Alert notes just a few recent economic statistics and developments. Also, there are regional differences that may need to be taken into consideration. For example, unemployment statistics may show a variation when comparing one region of the United States with another. Also, not all industries may benefit equally during a period of economic prosperity.

Fund performance varied greatly in 2000. Certain technology funds were very strong performers in 1999 and early 2000. However, beginning in March 2000, many technology stocks experienced severe price declines and a number of these funds have recently experienced negative portfolio performance. Investors in some of these strong performers, having expectations for a continuation of the exceptional returns they received in 1999, were quick to switch to other funds or seek investment options when their expectations were not met. Other funds, such as certain "value oriented" funds, experienced a significant number of redemptions in early 2000 as investors sought out higher returns. A number of these funds reported improved performance later in 2000, as equity investors began to focus their attention on non-technology market sectors.

Auditors of investment companies should consider the increased pressures that some investment companies may face to meet aggressive performance expectations. When auditing a client subject to increased pressures, auditors should consider whether such pressures could indicate a fraud risk factor. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316) provides guidance to auditors in fulfilling the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 states that the significance of risk factors varies widely for a particular entity. The auditor should exercise professional judgment when considering risk factors individually or in combination and whether there are specific controls that might mitigate the risk.

Help Desk—Further information on implementing SAS No. 82 is available in the AICPA publication *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk). This publication provides an in-depth understanding of SAS No. 82, supplemented by practice aids and examples including common fraud schemes and expanded audit procedures; sample engagement letters, representation letters, and workpaper documentation; and industry-specific fraud risk factors and guidance for several specialized industries, including investment companies. See the “Resource Central” section of this Audit Risk Alert for information on ordering AICPA publications.

Competitive Environment

Investment companies continue in 2000 to operate in an industry crowded with competitors, and to face competition from other financial institutions, such as broker-dealers, banks, and insurance companies, for the available pool of investor funds. Investors who previously looked to professional money managers to invest in the securities markets continue to feel empowered to direct their own equity trading activities. In recent years, the number of investors who trade online has grown rapidly, and this rapid growth is expected to continue over the next few years, as

well. The availability of financial information through sources such as the Internet has provided investors with expanded access to financial information previously available only to professional money managers.

The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (the Act) among other matters eliminates many of the existing barriers (notably the Glass-Steagall Act) that prohibited affiliations among organizations in the financial services industry, such as securities firms, banks, and insurance companies. The Act provides for a financial holding company structure (with the Fed serving as an umbrella regulator). The Act may provide opportunities as well as challenges for investment companies. For example, to the extent that this legislation allows financial institutions to enter into new lines of business and affiliate with banks or insurance companies, there may also be additional challenges from an increase in competition from other financial services organizations that are similarly expanding their product lines. Auditors should be alert for any changes in the investment company's business, including its products and services, related parties, and changes to applicable regulations that may follow in the wake of the Act.

The Act also requires that financial institutions must provide its customers with a notice of its privacy policies and practices. The Act restricts the disclosure of nonpublic customer information by financial institutions. All financial institutions must provide customers the opportunity to "opt-out" of the sharing of the customers' nonpublic information with unaffiliated third parties. See a related discussion "SEC Regulations" in the "Regulatory Developments" section of this Audit Risk Alert.

Some investment companies have responded to competitive pressures by seeking new ways to distribute their products to investors and maintain fund growth, including providing more information to investors through the Internet, a development that has changed how investors buy, sell, and research mutual funds. To meet the needs of investors and to implement the technological improvements needed to facilitate the rapid growth of electronic business (e-business), investment companies continue in 2000 to focus on information technology systems enhance-

ments. See the related discussion “E-Business” in the “Audit Issues and Developments” section of this Audit Risk Alert.

To meet investor needs, certain load funds have changed to no-load versions, and conversely some investment companies that traditionally sold no-load funds directly to investors have started adding load funds. Other fees structures have been established in which the investor can choose to pay a set fee based on a percentage of assets, rather than a front-end load for an individual fund purchase. Also, some mutual funds have added redemption fees to discourage “in and out” activity from market timers.

Because of the heightened investor interest in technology investments in 1999 and early 2000, a number of technology-oriented or aggressive-growth mutual funds began to invest in venture-capital type investments, in the form of either unregistered shares in already-public companies or “pre-IPO” holdings. Such investments are inherently more difficult to value than shares that are freely traded on a quoted market. Also, in some cases, these investments later became freely tradable in a public market, through either a public registration or other means. The guidance provided in Securities and Exchange Commission (SEC) Accounting Series Releases Nos. 113 and 118 and a recent SEC Division of Investment Management staff interpretive letter (see the related discussion “SEC Staff Interpretive Letter—Securities Valuation” in the “Regulatory Developments” section of this Audit Risk Alert), and concerns expressed by the Financial Accounting Standards Board (FASB) in the clearance of the new AICPA Industry Audit Guide *Audits of Investment Companies* (see the related discussion “New AICPA Audit and Accounting Guide, *Audits of Investment Companies*” in the “Audit Issues and Developments” section of this Audit Risk Alert), should be considered by preparers and auditors in assessing the valuation of these investments, as well as other illiquid or “fair-valued” investments.

Merger Activity

The increased number of mergers of investment companies of recent years continued in 2000. Auditors involved in fund mergers should consult the instructions in SEC Form N-14 and Article

11 of Regulation S-X, as well as prior SEC “Dear CFO” letters, to understand the requirements for pro forma financial statements in merger proxy statement and prospectus filings. Additionally, the determination of the accounting survivor in a fund merger may be complex, and at times the legal survivor may not be the accounting survivor. The SEC staff has stated that continuity and dominance in the following criteria should be considered in identifying the accounting survivor:

- Portfolio management
- Portfolio composition
- Investment objectives, policies, and restrictions
- Expense structures and ratios
- Relative asset size

Auditors should consider the impact of structural changes resulting from merger activity on the investment company’s internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*¹ (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor’s consideration of an entity’s internal control in an audit of financial statements in accordance with GAAS. SAS No. 55 states, among other matters, that the auditor should obtain sufficient knowledge of the entity’s risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. Because a merger can result in the gain or loss of an investment company client, auditors should also be familiar with the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). SAS No. 84 provides

1. See the “On the Horizon” section of this Audit Risk Alert for a discussion of the proposed Statement on Auditing Standards (SAS) that would amend SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

guidance on communications between predecessor and successor auditors when a change of auditors is in progress or has taken place. See the discussion “A Change of Auditors” in the “Audit Issues and Developments” section of this Audit Risk Alert.

Decimalization

Decimalization refers to the conversion of securities from fractional pricing (eighths and sixteenths of a dollar) to decimal pricing (dollars and cents). Under decimalization, securities can be priced in smaller increments. (See the related discussion of the timetable for conversion to decimal pricing in “Other Recent SEC Developments” in the “Regulatory Developments” section in this Audit Risk Alert.)

Investment companies will likely be addressing the impact of decimalization on their organizations. Investment companies, for example, may have implemented, and may be continuing to implement, system changes necessary to convert to decimal pricing.

Executive Summary—Economic and Industry Developments

- The auditor should obtain a knowledge of matters that relate to the nature of the entity’s business, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions, as they relate to the audit.
- Fund performance varied greatly in 2000. Certain technology funds, which were very strong performers in 1999 and early 2000, experienced negative portfolio performance later in 2000. Auditors of investment companies should consider the increased pressures that some investment companies may face to meet aggressive performance expectations. When auditing a client subject to increased pressures, auditors should consider whether such pressures could indicate a fraud risk factor.
- Investment companies continue in 2000 to operate in an industry crowded with competitors, and to face competition from other financial institutions, such as broker-dealers, banks, and insurance companies, for the available pool of investor funds.

-
-
- The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 among other matters eliminates many of the existing barriers (notably the Glass-Steagall Act) that prohibited affiliations among organizations in the financial services industry, such as securities firms, banks, and insurance companies.
 - The increased number of mergers of investment companies of recent years continued in 2000. Auditors should consider the impact of structural changes resulting from merger activity on the investment company's internal control. Because a merger can result in the gain or loss of an investment company client, auditors should also be familiar with the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors*.
 - Investment companies will likely be addressing the impact of decimalization on their organizations. Investment companies, for example, may have implemented, and may be continuing to implement, system changes necessary to convert to decimal pricing.
-

Regulatory Developments²

SEC Regulations

What are some of the final rules issued during the past year by the SEC that auditors of investment companies should be aware of?

SAS No. 22, *Planning and Supervision*, states that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates as they relate to the audit, including, among other matters, government regulations. Auditors should note that investment companies are subject to a number of regulatory requirements. For example, many investment companies

-
2. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations and other documents that are discussed in this section of the Alert. The complete text of Securities and Exchange Commission (SEC) final and proposed rules, including the final rules discussed in this section of the Alert and rules adopted subsequent to the writing of this Alert, as well as other SEC information, can be obtained from the SEC Web site at www.sec.gov. See the "Information Sources" section of this Alert for a list of Internet resources, including some Web sites, that can provide additional information on regulatory issues and developments.

are required to register under the Investment Company Act of 1940 (Investment Company Act), the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), and with various state security commissions. Also, the Investment Advisers Act of 1940 (Advisers Act) requires persons paid to render investment advice to individuals or institutions, including investment companies, to register, and it regulates their conduct and contracts.

The federal securities laws are supplemented by formal rules and regulations. The SEC also issues a variety of other releases and statements, including its financial reporting releases and releases under the Securities Act, the Exchange Act, the Investment Company Act, and the Advisers Act. Many apply to the investment company industry. The auditor should be familiar with them and with the SEC registration and reporting forms.

In addition, auditors of investment companies should be aware of the requirements of SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). SAS No. 54 prescribes the nature and extent of the consideration that the auditor should give to the possibility of illegal acts by a client in audits of financial statements in accordance with GAAS. The term *illegal acts* refers to violations of laws or governmental regulations. SAS No. 54 states, in part, that the auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. Entities may be affected by many other laws or regulations relating more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

When an auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

The following is a summary of some of the rules that the SEC issued during the past year.

- *EDGAR System and EDGAR Filer Manual.* The SEC adopted several final rules in 2000 related to the Electronic Data Gathering, Analysis and Retrieval (EDGAR) System and the EDGAR Filer Manual, including the discontinuing of financial data schedules for investment company filings.
- *Adoption of updated EDGAR Filer Manual.* The SEC issued a final rule adopting an updated edition of the EDGAR Filer Manual and providing for its incorporation by reference into the Code of Federal Regulations. The updated EDGAR Filer Manual describes the technical formatting requirements for the preparation and submission of electronic filings through the EDGAR System. The purpose of the new version of EDGAR and the Filer Manual (Release 6.75) is to add new form types and delete several old ones. Effective date: January 24, 2000.
- *Rulemaking for EDGAR System.* The SEC implemented the next stage of modernization of the EDGAR System (EDGAR Release 7.0) for filers. The SEC adopted amendments to its rules to reflect changes in filing requirements attributable to the EDGAR Release 7.0, as well as certain other changes to clarify or update rules. Effective date: May 30, 2000; applies to filings submitted on or after that date, with certain specified exceptions.
- *Adoption of updated EDGAR Filer Manual.* The SEC adopted revisions to the EDGAR Filer Manual and provided for their incorporation by reference into the Code of Federal Regulations. The SEC adopted a new Volume II of the EDGAR Filer Manual, which describes the technical formatting requirements for the preparation and submission of filings through the EDGAR system and describes the requirements for filing using the EDGARLink. Effective date: May 30, 2000. The SEC subsequently adopted a final rule updating the provisions of the EDGAR Filer Manual governing the old Legacy EDGAR

system (Volume 1) and the filing of Form N-SAR documents (Volume III), to reflect the limited changes being made to these systems with the implementation of EDGAR Release 7.0. Effective date: June 23, 2000.

- *Privacy of consumer financial information.* The SEC adopted regulation S-P, privacy rules promulgated under section 504 of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. Section 504 requires the SEC and other federal agencies to adopt rules implementing notice requirements and restrictions on a financial institution's ability to disclose nonpublic personal information about consumers. The Act requires the SEC to establish for financial institutions appropriate standards to protect consumer information. The final rules implement these requirements of the Act with respect to investment advisers registered with the SEC, brokers, dealers, and investment companies, which are financial institutions subject to the SEC's jurisdiction under the Act. Effective date: November 13, 2000.
- *Selective disclosure and insider trading.* The SEC adopted new Regulation FD (Fair Disclosure), rule 10b5-1, rule 10b5-2, and amendments to Form 8-K. The rules are designed to promote the full and fair disclosure of information by issuers of material nonpublic information, and to clarify and enhance existing prohibitions against insider trading. Regulation FD is a new issuer disclosure rule that addresses selective disclosure. Regulation FD provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of the information. The timing of the required public disclosure depends on whether the selective disclosure was intentional or nonintentional. The required public disclosure may be made by filing or furnishing a Form 8-K or by another method or combination of methods that is reasonably designed to effect

broad, nonexclusionary distribution of the information to the public. Effective date: October 23, 2000.

- *Exemption from section 101(c)(1) of the Electronic Signatures in Global and National Commerce Act for registered investment companies.* The SEC adopted an interim final rule, rule 160 under the Securities Act, to exempt from the consumer consent requirements of the Electronic Signatures in Global and National Commerce Act prospectuses of registered investment companies that are used only to permit supplemental sales literature to be provided to prospective investors. The rule permits a registered investment company to provide its prospectus and supplemental sales literature on its Web site or by other electronic means without first obtaining investor consent to the electronic format of the prospectus. The SEC also clarified its interpretation on the responsibility of registered investment companies for hyperlinks to third-party Web sites from their advertisements or sales literature. Effective date: October 1, 2000, except for parts 231 and 271, which are effective July 27, 2000.
- *Offer and sale of securities to Canadian tax-deferred retirement savings accounts.* The SEC has adopted rule 7d-2 under the Investment Company Act that provides that a foreign fund's offer of securities to Canadian/U.S. Participants (individuals who have established Canadian retirement accounts and later moved to the United States), and a sale to their accounts, are not "public offerings" that would require the fund to register as an investment company under that Act. Effective date: June 23, 2000.
- *Custody of investment company assets outside the United States.* The SEC adopted a new rule 17f-7 and conforming amendments to rule 7d-1 and 17f-4 under the Investment Company Act to establish new standards governing the maintenance of an investment company's assets with a foreign securities depository. These standards are established to provide a framework under which an investment company can protect its assets while maintaining them with a

foreign securities depository. Effective date: June 12, 2000.
Compliance date: July 2, 2001.

- *Audit committees disclosure.* The SEC adopted new Item 306 of Regulation S-K and item 306 of Regulation S-B, as well as amendments to rule 10-01 of Regulation S-X; item 310 of Regulation S-B; item 7 of Schedule 14A under the Exchange Act; and item 302 of Regulation S-K. The new rules and rule amendments, which are based in large measure on recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, are designed to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. These rules apply to closed-end investment companies registered under the Securities Act.³ Effective date: January 31, 2000.
- *Cross-border tender and exchange offers, business combinations, and rights offerings.* The SEC adopted tender offer and Securities Act registration exemptive rules for cross-border tender and exchange offers, business combinations, and rights offerings related to the securities of foreign companies. The purpose of the exemptions is to facilitate U.S. investor participation in these types of transactions. The registration exemptions for rights offerings, business combinations, and exchange offers provided by new rules 801 and 802 adopted under the Securities Act are available for securities issued by closed-end investment companies that are registered under the Investment Company Act. The Tier I and Tier II tender offer exemptions are also available if the subject company is a closed-end investment company that is registered under the Investment Company Act. Effective date: January 24, 2000, with certain exceptions.
- *Delivery of disclosure documents to households.* The SEC adopted amendments to rules 30d-1 and 30d-2 under the Investment Company Act to permit householding (the deliv-

.....
3. The SEC has a separate initiative relating to the boards of directors of all investment companies, including open-end investment companies. Proposed rules, which were published on October 14, 1999, can be found on the SEC Web site, www.sec.gov.

ery of one prospectus or shareholder report to investors who share an address) of annual and semiannual reports under substantially the same conditions as those in the new rule 154 under the Securities Act. Under the new rule 154, a prospectus is considered delivered to all investors at a shared address, for the purposes of the federal securities laws, if the person relying on the rule delivers the prospectus to the shared address and the investors consent to the delivery of a single prospectus. The rule applies to prospectuses and to prospectus supplements. Effective date: December 20, 1999.

The following is a summary of some of the rules that the SEC issued during the past year for investment advisers.

- *Electronic filing by investment advisers, amendments to Form ADV.* The SEC adopted new rules and rule amendments under the Advisers Act to require that advisers registered with the SEC make filings with the SEC under the Advisor's Act electronically through the Investment Adviser Registration Depository (IARD). Amendments to Forms ADV and ADV-W that prepare those forms for electronic filing were also adopted. The new rules implement the SEC's statutory mandate to create a one-stop electronic filing system for investment advisers and provide investors with a readily accessible database of information about investment advisers and persons associated with them. Effective date: October 10, 2000. The transition to electronic filing will begin in January 2001.
- *Temporary exemption for certain investment advisers.* The SEC adopted amendments to the rule under the Investment Company Act that permits an investment adviser to advise an investment company under a temporary contract that the investment company's shareholders have not approved. The amendments expand the circumstances in which the exemption provided by the rule is available, to include a merger or similar business combination involving an investment company's adviser. The maximum duration of a temporary contract is also lengthened by the amendments. The amendments permit more investment advisers to rely on the rule, rather than seek individual exemptions from the SEC,

and will continue to protect the interest of the investors pending their vote on a new advisory contract. Effective date: December 13, 1999.

SEC—Auditor Independence Requirements

In November 2000 the SEC adopted amendments to its auditor independence requirements. Specifically, it amended Rule 2-01 of regulation S-X and Item 9 of Schedule 14A under the Securities Exchange Act of 1934. These amendments are intended to modernize the SEC's rules for determining whether an auditor is independent in light of—

- Investments by auditors or their family members in audit clients.
- Employment relationships between auditors or their family members and audit clients.
- The scope of services provided by audit firms to their audit clients.

Help Desk—Visit the SEC's Web site at www.sec.gov/rules/final/33-7919.htm for the final rules. Also, see the new AICPA Audit Risk Alerts, *The ABCs of Independence—2000/01* and *SEC Alert*, for additional discussions about the amendments.

Other Recent SEC Developments

SEC Interpretative Release—*Interpretive Matters Concerning Independent Directors of Investment Companies*⁴

The SEC published their views concerning particular issues under the Investment Company Act that pertain to the independent directors of registered investment companies. *Interpretive Matters Concerning Independent Directors of Investment Companies* addresses

.....
4. The SEC from time to time will provide guidance relating to topics of general interest to the business and investment communities by issuing an interpretive release in which it publishes its views on the subject matter and interprets the federal securities laws and its own regulations. SEC interpretive releases are available on the SEC Web site www.sec.gov.

the views of the SEC staff concerning a number of interpretive issues under the Investment Company Act that relate to independent directors, and also briefly describes the role of the SEC in connection with certain disputes between independent fund directors and fund management. Effective date: October 14, 1999.

SEC Interpretive Release—*Use of Electronic Media*⁵

In April 2000, the SEC issued the Interpretive Release *Use of Electronic Media*, discussing the application of the federal securities laws to electronic media. The Interpretive Release is designed to provide guidance to issuers of all types, and addresses the use of electronic media in three areas—

1. Updates previous SEC guidance on the use of electronic media to deliver documents under the federal securities laws.
2. Discusses an issuer's liability for Web site content.
3. Outlines basic legal principles that issuers and market intermediaries should consider in conducting online offerings.

The Interpretive Release includes a section on online offerings, which among other matters notes that the SEC Division of Corporate Finance has reviewed numerous procedures in connection with online distributions of initial public offerings (IPOs), and has issued a no-action letter regarding permissible procedures for the use of the Internet in IPOs. Effective date: May 4, 2000.

SEC Staff Interpretive Letter—Securities Valuation

In December 1999, the staff of the SEC Division of Investment Management issued an interpretive letter discussing three issues relating to funds' responsibilities for pricing portfolio securities.⁶ The letter clarified that market quotations for portfolio securities are not readily available when the exchanges or markets on which those securities trade do not open for an entire day, and that funds accordingly must price those securities based on a determination

.....
5. See footnote 4.

6. Letter from Douglas Scheidt, associate director and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, December 8, 1999.

of fair value; provided additional guidance regarding the process of fair value pricing, and described certain factors that funds should consider when pricing portfolio securities at fair value; and discussed the obligations of fund boards of directors for pricing portfolio securities at fair value, and measures that boards may take when discharging those responsibilities. The letter reaffirmed that SEC Accounting Series Releases Nos. 113 and 118 continue to represent the views of the SEC on securities valuation.

Decimalization

In June 2000 the SEC issued an order requiring the exchanges and the National Association of Securities Dealers (NASD) to submit a plan for—

- Phasing in decimal pricing for listed stocks and certain options starting no later than September 5, 2000.
- Phasing in decimal pricing for all NASDAQ securities beginning no later than March 12, 2001.
- Pricing all securities in decimals no later than April 9, 2001.

A comprehensive phase-in plan was submitted to the SEC in July 2000 that called for the decimal pricing to begin in thirteen exchange-listed securities and options on those securities on August 28, 2000; expanded decimal pricing to fifty to one hundred additional exchange-listed securities and their options on September 25, 2000; and provided that the decimal pricing for all remaining exchange-listed securities and all options potentially could begin as early as December 2000. The decision to convert all remaining exchange-listed securities and options between the period December 2000 and April 9, 2001, would be based on an assessment of industry readiness. The plan also calls for limited decimal pricing in NASDAQ securities no later than March 12, 2001, and the completion of the decimal conversion for all equity securities and options on or before April 9, 2001.

Consolidated Tape Association

Over the last year, the SEC has received a number of complaints from investors and issuers about confusing end-of-day securities

prices. The confusion has arisen from inconsistencies among market vendors and media concerning when they take end-of-day “snapshots” of stock prices. In October 2000, the SEC announced that the stock markets that comprise the Consolidated Tape Association (CTA) have agreed to implement a plan that would help investors distinguish after-hours and regular session trades. Market data vendors supply tape data to subscribers. Financial news services and Internet sites use the data to display price and volume information. Newspapers use the data for daily stock tables. Additional information on the consolidated tape is available on the SEC Web site at www.sec.gov.

SEC Annual “Dear CFO” Letter

.....
What are the significant issues raised in the most recent “Dear CFO” letter?
.....

The accounting staff of the Division of Investment Management of the SEC periodically issues a generic letter addressed to the chief financial officers (CFOs) of investment company registrants and their independent public accountants outlining key issues addressed by the SEC during the year. These letters point out the SEC’s areas of concern and accordingly may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of investment companies. The following summary highlights the areas of concern cited in the December 1999 letter.⁷

Management’s Statement Regarding Compliance

The letter addresses rules under the Investment Company Act and the Advisers Act that require that an independent accountant conduct an examination of the securities held by a regulated entity. Specifically, rules 17f-1 and 17f-2 under the Investment Company Act require examinations by independent accountants when securities are maintained in the custody of a member of a national securities exchange, or the investment company itself maintains custody, respectively. Rule 206(4)-2 of the Advisers Act similarly

.....
⁷ Look for the next “Dear CFO” letter, expected in early 2001, on the SEC Web site at www.sec.gov.

requires an examination when the adviser maintains custody or possession of client funds or securities. In examining filings on forms N-17f-1, N-17f-2 and ADV-E, the SEC noted that many registrants had not included Management's Statement Regarding Compliance in their filings. The letter reminds registrants that to be a complete filing, registrants must attach Management's Statement Regarding Compliance to the Report of Independent Accountants in filings on forms N-17f-1, N-17f-2 and ADV-E.

Accounting for Reimbursement of Expense Waivers

The letter states that during examinations of registrants, the SEC staff has noted receivables from fund advisers under expense reimbursement plans, which have been outstanding for periods extending beyond one year, and which did not have corresponding valuation reserves reducing the outstanding receivable balance for potentially uncollectible amounts. Consistent with generally accepted accounting principles (GAAP), fund management should consider the collectibility of any receivable from an adviser, particularly in circumstances where the receivable is not fully paid as frequently as the adviser receives payment for services provided under the advisory agreement. Also, the letter reminds auditors of the requirement under GAAS to satisfy themselves that receivables from an adviser or third party are properly valued to reflect collectibility concerns.

Financial Highlights and Fee Table Disclosures

The letter discusses the reviews of a number of financial highlight tables where registrants have incorrectly calculated the ratio of expenses to average net assets (the expense ratio). A number of registrants are incorrectly reducing total expenses by brokerage offsets, custodial credits and/or other expense reductions. Certain registrants are excluding interest and dividend expenses attributable to securities sold short from total expenses. Only fee waivers or reimbursements may reduce total expenses. The letter also states that in reviewing prospectuses, it was noted that some registrants were reducing the fee table expense percentages with custodial credits and/or other third-party offset arrangements. The use of these credits and offsets to reduce fund expense ratios is inconsistent

with the requirements of the form. Only contractual waivers or reimbursements may be used to reduce expense percentages in the fee table.

Holding Period for Seed Capital Shares

The letter addresses questions received regarding the holding period for shares purchased pursuant to section 14(a) of the Investment Company Act as part of a fund's initial registration with the SEC. Some registrants and their sponsors believe that the holding period for seed capital shares is related to the period over which a fund amortizes organization costs. With the implementation of Statement of Position (SOP) 98-5, *Reporting on the Costs of Start-Up Activities*, the ability to capitalize and amortize organization costs over a five-year period was eliminated. Many registrants and sponsors have asked if they may redeem seed capital shares shortly after the fund becomes effective. The letter reminds registrants and their sponsors that the redemption of the seed capital shares is subject to the requirements of section 14(a) of the Investment Company Act. The legality of a sponsor redeeming seed capital shares depends on the facts and circumstances of the redemption and is not based on the accounting for organization costs.

Adviser Accounting for Offering Costs

The letter notes that the accounting treatment for initial offering costs of closed-end funds is addressed in Emerging Issues Task Force (EITF) Topic D-76, *Accounting by Advisors for Offering Costs Paid on Behalf of Funds, When the Advisor Does Not Receive Both 12b-1 Fees and Contingent Deferred Sales Charges*, and states that the FASB staff concluded that an adviser could not capitalize the offering costs of closed-end funds because the adviser was not receiving both a continuing distribution fee and a contingent deferred sales charge (CDSC). The letter also states that under EITF Issue No. 85-24, *Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge*, advisers of open-end funds are allowed to capitalize offering costs if the adviser is compensated for the offering costs through both rule 12b-1 fees (a continuing distribution fee) and CDSCs. The letter states that certain closed-end funds, such as hybrid or interval

funds (hybrid funds), objected to the FASB staff's position on the basis that hybrid funds have many of the same features as open-end funds, and that in an update to Topic D-76, the FASB staff concluded that an adviser to a hybrid fund may capitalize initial offering costs if the adviser receives both a distribution fee and early withdrawal charges. The letter states that the SEC staff would not object to the capitalization of initial offering costs in these situations provided the investment company registrant has received an exemptive order allowing both distribution fees and early withdrawal charges.

Independence Standards Board Recordkeeping Requirements

The letter discusses the Independence Standards Board's (ISB's) first standard, *Independence Discussions with Audit Committees*.⁸ The standard requires auditors to discuss their independence with either the company's board of directors or audit committee. All relationships between the auditor and its related entities, and the company and its related entities, that may affect an auditor's independence must be disclosed by the auditor in writing. Also, the auditor must affirm, in writing, that in their judgment they are independent of the company. The letter reminds registrants that this correspondence is subject to inspection during periodic and other reviews.

Issuance of AICPA Audit and Accounting Guide⁹

The letter states that on September 14, 1999, the AICPA Accounting Standards Executive Committee (AcSEC) approved the AICPA Audit and Accounting Guide for investment companies. The Audit Guide outlines changes to existing practice that, in certain areas, differs from the requirements of Regulation S-X under the federal securities laws. The letter reminds registrants that notwithstanding the Audit Guide, the financial statements of registered investment companies must be prepared in accordance with the requirements of Regulation S-X.

.....
8. Additional information on the activities of the Independence Standards Board (ISB) is available on the ISB Web site at www.cpaIndependence.org.

9. See a related discussion "New AICPA Audit and Accounting Guide, *Audits of Investment Companies*," in the "Audit Issues and Developments" section of this Audit Risk Alert.

Financial Statements Submitted via EDGAR

The letter reminds registrants that within ten days of distribution to the shareholders, all semi-annual and annual reports must be filed with the SEC via EDGAR. The letter also states that financial statements can be incorporated into a registration statement, post-effective amendment or other document by reference, but only if the requirements of rule 303 of Regulation S-T are met.

Audit Issues and Developments¹⁰

New AICPA Audit and Accounting Guide, *Audits of Investment Companies*

.....
What are some of the highlights of the new AICPA Audit and Accounting Guide Audits of Investment Companies?
.....

The AICPA has issued a new Audit and Accounting Guide, *Audits of Investment Companies*. This new Guide was prepared by the AICPA Investment Companies Guide Task Force to assist investment companies in preparing financial statements in conformity with GAAP and to assist independent auditors in auditing and reporting on those financial statements in accordance with GAAS.

The Guide describes operating conditions and auditing procedures unique to the investment company industry and illustrates the form and content of various investment company financial statements and related disclosures. The preface to the Guide includes a "Summary of New Accounting Standards."

Chapter 1 in the Guide discusses the kinds of companies considered to be investment companies to which the provisions of the Guide apply. The FASB has expressed concerns regarding both the clarity of the scope of the Guide and the use of a blockage factor in estimating the fair value of certain unrestricted investments that have a quoted market price in an active market. As a result, AcSEC is undertaking two separate projects to address those con-

.....
¹⁰ Readers should refer to the full text of the auditing standards and other pronouncements that are discussed in this section of the Audit Risk Alert.

cerns. For both issues, the new Guide includes “standstill” provisions on current accounting practice as follows:

- Until the project to clarify the scope of the Guide is finalized, entities should consistently follow their current accounting policies for determining whether the provisions of the Guide apply to investees of the entity or to subsidiaries that are controlled by the entity. Further discussion of this matter appears in the FASB staff announcement in EITF Topic D-74, *Issues Concerning the Scope of the AICPA Audit Guide on Investment Companies*.
- If it was an entity’s accounting policy in investment company financial statements issued for fiscal years ending on or before May 31, 2000, to apply a blockage factor to estimate the fair value of certain unrestricted investments that have a quoted market price in an active market, the entity may continue to apply that policy to those and similar investments. However, disclosure of the existence of such a policy is required. Otherwise, an entity may not elect to adopt such a policy pending the completion of AcSEC’s project on this matter or FASB’s project on measuring financial instruments at fair value.

Additional information on AcSEC projects is available on the AICPA Web site at www.aicpa.org.

Impact on Other Literature

The Guide supersedes the AICPA Audit and Accounting Guide *Audits of Investment Companies* (with conforming changes as of May 1, 1998), and SOP 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*. The Guide incorporates the following authoritative material specific to investment companies:

- SOP 89-2, *Reports on Audited Financial Statements of Investment Companies*
- SOP 89-7, *Report on the Internal Control Structure in Audits of Investment Companies*

-
-
- SOP 93-1, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies*
 - SOP 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies*
 - SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*
 - SOP 95-3, *Accounting for Certain Distribution Costs of Investment Companies*

Effective Date and Transition

The accounting and financial reporting provisions of the Guide that describe changes required by other new authoritative literature should be applied using the effective dates specified in that literature. Except as described in the Guide, changes in accounting and financial reporting required by the Guide shall be applied prospectively and shall be effective for annual financial statements issued for fiscal years beginning after December 15, 2000, and for interim financial statements issued after initial application. Earlier application is permitted. Restatement of previously issued financial statements is not permitted.

See the “Resource Central” section of this Audit Risk Alert for order information.

Auditing Derivatives

What guidance is available for auditing derivative instruments?

The topic of derivatives takes center stage this year, from both the accounting and auditing perspectives. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended), issued in June 1998, became effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. In September of this year, the Auditing Standards Board (ASB) issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 391). SAS No. 92, which will supersede SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1,

AU sec. 332), is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted.

Guidance for Auditors

SAS No. 92 provides guidance for auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. The guidance in the SAS applies to (1) derivative instruments, as defined by FASB Statement No. 133; (2) hedging activities in which the entity designates a derivative or a non-derivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting; and (3) *debt* and *equity securities*, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The matters addressed by SAS No. 92 include—

- *The need for special skills or knowledge.* Auditors may need special skills or knowledge to plan and perform procedures for certain assertions about derivatives and securities, such as the ability to identify a derivative that is embedded in a contract or agreement.
- *Consideration of audit risk and materiality.* SAS No. 92 offers examples of factors that affect inherent risk (that is, the susceptibility of an assertion to a material misstatement, assuming there are no related controls) for assertions about derivatives or securities. Such factors include the complexity of the features of the derivative or security, or the entity's experience with the derivative or security. The SAS also discusses control risk assessment; control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control.
- *Designing substantive procedures based on risk assessment.* Auditors assess inherent and control risk for assertions about derivatives and securities to determine the nature, timing, and extent of the substantive procedures to be performed. Substantive procedures for derivatives and securi-

ties should address the five categories of assertions presented in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326):

1. *Existence or occurrence*—Existence assertions address whether the derivatives and securities reported in the financial statements exist at the balance sheet date. Occurrence assertions address whether derivatives and securities transactions reported in the financial statements (as a part of earnings, other comprehensive income, or cash flows) occurred.
2. *Completeness*—Completeness assertions address whether all of the entity's derivatives and securities and the related transactions are reported in the financial statements.
3. *Rights and obligations*—Assertions about rights and obligations address whether the entity has the rights and obligations associated with derivatives and securities reported in the financial statements.
4. *Valuation*—Assertions about the valuation of derivatives and securities address whether the amounts reported in the financial statements were determined in conformity with GAAP. GAAP may require that a derivative or security be valued based on cost, the investee's financial results, or fair value. Also, GAAP for securities may vary depending on the type of security, the nature of the transaction, management's objectives related to the security, and the type of entity.
5. *Presentation and disclosure*—Assertions about presentation and disclosure address whether the classification, description, and disclosure of derivatives and securities in the entity's financial statements are in conformity with GAAP.

SAS No. 92 also discusses hedging activities and management representation issues.

An Audit Guide to complement the SAS has been developed by the ASB and is expected to be available in January 2001. The

Guide provides practical guidance for implementing the SAS in all types of audit engagements. The objective of the Guide is both to explain SAS No. 92 and to provide practical illustrations through the use of case studies.

The Guide will include an overview of derivatives and securities, and the general accounting considerations for them, as well as case studies that address topics such as the use of interest rate futures contracts to hedge the forecasted issuance of debt, the use of put options to hedge available-for-sale securities, the use of interest rate swaps to hedge existing debt, control risk considerations when service organizations provide securities services, inherent and control risk assessment, and designing substantive procedures based on risk assessments. See the “Resource Central” section of this Audit Risk Alert for order information.

E-Business

What are some of the audit considerations in an e-business environment?

The growth of e-business has been widespread and rapid in the financial services industry. It is likely that your investment company audit clients are feeling the impact. Even if the investment company itself hasn’t begun to develop an e-business strategy, it may still be affected by increased competition from those financial institutions that have implemented one.

As investors continue to become increasingly familiar and comfortable with using the Internet to get financial information and conduct business transactions, financial institutions continue to look for ways to use the Internet and other distribution channels to provide investors with product information and conduct financial transactions. Some investment companies, for example, may set up a Web site to provide customers with information about their investments. Other investment companies may take advantage of an e-business strategy in anticipation of lower transaction costs. Also, an investment company may establish a Web site to broaden its market reach beyond its traditional borders.

Transactions conducted in an e-business environment may have a significant effect on the audit process.¹¹ For example—

- Audit evidence that exists in electronic form may not be available for an indefinite period of time. Therefore, performing certain procedures after year end may be too late to gather sufficient, competent evidential matter.
- Electronic evidence may exist in a form that demands specialized skills and knowledge to access and interpret. Auditors without such skills are likely to require the assistance of a specialist.
- Because e-businesses may lack much of the physical evidence found in “old economy” clients, the auditor’s understanding of internal control will be especially critical in planning the audit and determining the nature, timing, and extent of substantive testing.

What are some of the professional standards that may take on increased importance in an e-business environment?

- SAS No. 31, *Evidential Matter*, as amended by SAS No. 80. SAS No. 31, as amended, provides guidance to auditors who have been engaged to audit financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically. SAS No. 31, as amended, states that the auditor’s specific objectives are the same whether information is processed manually or electronically.
- SAS No. 22, *Planning and Supervision*, points out some of the important considerations that should be addressed in the planning phase of the audit. Among those considerations are the need for the auditor to obtain knowledge about the entity’s business, its operating characteristics, types of products and services, production, distribution,

11. Although not all traditional brick-and-mortar businesses are moving toward e-business platforms, there is still a huge push toward adopting information technology (IT) solutions. Auditors should be alert to the risks that are likely to arise in such environments. Careful consideration should be given to the controls that surround IT systems, including proper segregation of key IT duties, systems design, software purchase and implementation, security, and backup and contingency planning.

and compensation methods, matters affecting the industry in which the client operates, changes in technology, and other matters. Given the unique characteristics of e-business entities, a sound understanding of these matters at the planning stage will be especially critical. Attention should also be given to the planning considerations discussed in SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 311).

- SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).¹² Auditors should consider the guidance in SAS No. 55. As discussed in SAS No. 55, control risk may be affected by such factors as new or revamped information systems, rapid growth, new technologies and other circumstances.
- SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU 336). The technological skills required to fully understand the operations of an e-business and the manner in which the business is transacted may be highly specialized. While an auditor may have the requisite skill set to address the issues that arise in an e-business environment, some additional training may be required, and in some cases the use of a technology specialist may be advisable. SAS No. 73 provides guidance to the auditor who uses the work of a specialist in performing an audit in accordance with GAAS.

Help Desk—Look for the newly introduced Audit Risk Alert *E-Business Industry Developments—2000/01* for comprehensive discussions of the considerations unique to the e-business environment. See the “Resource Central” section of this Audit Risk Alert for order information.

.....
¹². See the “On the Horizon” section of this Audit Risk Alert for a discussion of the proposed SAS that would amend SAS No. 55.

ISB Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*¹³

What are the requirements of the ISB's Standard No. 2, Certain Independence Implications of Audits of Mutual Funds and Related Entities?

Issued by the ISB in December 1999 and amended in July 2000, this independence standard requires the audit firm, certain of its retirement plans, the audit engagement team, and those in a position to influence the audit, when the firm is auditing mutual funds, to be independent of all sister funds and all related non-fund entities. In addition, when auditing a related nonfund entity, independence would be required by the same entities and individuals of all funds in the mutual fund complex.

This standard permits direct investment in nonaudit client sister funds by all other partners and employees of the firm. Spouses and dependents of partners, other than those on the audit engagement team or in a position to influence the audit, may also invest through an employee benefit plan in mutual funds that are audit clients.

This standard is effective with respect to audits of financial statements for periods beginning sixty days after existing rules of the SEC are modified to remove conflicts with the standard. See the discussion "SEC—Auditor Independence Requirements" in the "Regulatory Developments" section of this Alert. Notification of relevant actions by the SEC will be posted to the ISB's Web Site at www.cpaindependence.org.

Help Desk—The full text of ISB Standards and Interpretations, along with information on other ISB publications and exposure drafts, are posted on the ISB's Web site, www.cpaindependence.org.

13. Additional discussion of independence issues can be found in the AICPA general *Audit Risk Alert 2000/01*. Also, see the newly introduced AICPA Audit Risk Alert *The ABCs of Independence*. See the "Resource Central" section of this Audit Risk Alert for order information.

Money Laundering Activities¹⁴

What is money laundering?

Money laundering is the funneling of cash or other funds generated from illegal activities, often through legitimate financial institutions or businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international boundaries. Current estimates of the size of the global annual “gross money laundering product” range from \$500 billion to \$1 trillion.¹⁵

Criminals use a wide variety of financial institutions and professional advisers to launder the proceeds of crime, and, according to the U.S. Department of the Treasury, securities investment companies may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, new technologies, and new distribution channels—generate important business opportunities, but they also generate risks for securities investment companies, including increased money laundering vulnerability.

As these industry trends continue, as money launderers increasingly look for a wide range of financial services and conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other non-bank financial institutions make it more difficult for them to evade detection, the securities investment company industry may become increasingly vulnerable to money laundering and more attractive to money launderers.

While money laundering activities and methods become increasingly complex and ingenious, its “operations” tend to consist of three basic stages or processes—placement, layering, and integration.

Placement is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial

14. This section of the Alert was drafted after consultation with the U.S. Department of Treasury.

15. By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

system in such a manner as to avoid detection by bank and non-bank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends, and law enforcement strategies and techniques to keep their proceeds concealed, their methods secret, and their identities and professional resources anonymous. A common placement technique is the structuring¹⁶ of cash deposits into legitimate financial institution accounts, converting cash into other monetary instruments or money transfers, and using these instruments to conduct transactions through another financial institution. Another placement technique is customers making large deposits and investments with laundered proceeds in the form of monetary instruments, bearer instruments, or third-party checks, especially through third-party agents.

Layering is the process of generating a series or layers of transactions to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include electronic fund transfers, often directly or subsequently into a “bank secrecy haven” or a jurisdiction with lax recordkeeping and reporting requirements; withdrawals of already-placed deposits in the form of highly liquid monetary instruments, such as money orders and travelers checks; and requests for account transfers or checks made payable to third parties with whom the account-holder appears to have no obvious relationship.

Integration, the final money laundering stage, is the unnoticed reinsertion of successfully laundered untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions.

Money launderers tend to use the victimized business entity as a conduit for illicit funds that need to be distanced from their source as quickly as possible in an undetected manner. Consequently, it is less likely that money laundering will be detected in financial statement audits than other types of illegal activities. In

.....
16. *Structuring* means breaking up large amounts of currency into smaller amounts to conduct transactions in such a manner as to avoid currency reporting or other Bank Secrecy Act requirements.

addition, money laundering activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations in account balances rather than cumulative changes. Money laundering is considered to be an illegal act which will often have an *indirect* effect on financial statement amounts under SAS No. 54. Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

In June 2000, the OECD's Paris-based Financial Action Task Force (FATF), the world's anti-money laundering watchdog intergovernmental organization, issued a *Review to Identify Non-Cooperative Countries or Territories*, expressly identifying fifteen governments as noncooperative with other countries and jurisdictions in combating money laundering. Subsequently, in July, the U.S. Treasury Department followed suit with a series of Financial Crimes Enforcement Network (FinCEN) country Advisories which asked U.S. banks and other financial institutions to pay closer attention to transactions linked to these countries.

A description of federal regulations pertaining to money laundering appears in appendix A, titled "Federal Regulations Related to Money Laundering," of this Audit Risk Alert.

Executive Summary—Money Laundering Activities

- Money laundering is a global activity in which cash or other funds from illegal activities are funneled through legitimate businesses to conceal the initial source of funds.
- Money laundering usually results in large amounts of illicit proceeds that need to be distanced from their source as quickly as possible,

and is less likely to be detected in a financial statement audit than other types of illegal activities.

- Under SAS No. 54, money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. The auditor does not have a detection responsibility for such illegal acts. However, auditors should be aware of the possibility that such illegal acts may have occurred and the potential risk to the subject of the audit.
-

A Change of Auditors

What are the responsibilities of predecessor and successor auditors under SAS No. 84?

The “Economic and Industry Developments” section of this Alert notes that the increased number of mergers of investment companies of recent years continued in 2000. With the increasing level of merger activity there likely comes a corresponding increase in changes in auditors. Thus, auditors may be more likely to find themselves in either the role of a predecessor or successor auditor this year. SAS No. 84, *Communications Between Predecessor and Successor Auditors*, which superseded SAS No. 7 of the same name, provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place.

To begin with, SAS No. 84 redefines the terms *predecessor*¹⁷ and *successor* auditors. A *predecessor auditor* (the predecessor) is defined as an auditor who—

1. Has reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of any subsequent financial statements.
2. Has resigned, declined to stand for reappointment, or been notified that his or her services have been, or may be, terminated.

17. See “SAS No. 93, *Omnibus Statement on Auditing Standards—2000*” in the “New Auditing and Attestation Pronouncements” section of this Alert for a discussion of the new SAS No. 93, which among other matters, amends SAS No. 84 to clarify the definition of predecessor auditor, effective for audits of financial statements for periods ending on or after June 30, 2001, with earlier application permitted.

A *successor auditor* (the successor) is defined as an auditor who is considering accepting an engagement to audit financial statements but has not communicated with the predecessor auditor, as required by SAS No. 84, and to an auditor who has accepted such an engagement.

SAS No. 84 cites as a necessary procedure on the part of the successor, the inquiry of the predecessor. The successor, upon receiving permission from the prospective client, should make specific and reasonable inquiries of the predecessor regarding matters that will assist the successor in determining whether to accept the engagement. Though the successor may consider making any reasonable inquiry, SAS No. 84 requires that matters subject to inquiry should include the following:

- Information that might bear on the integrity of management
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters
- Communications to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal control-related matters
- The predecessor's understanding as to the reasons for the change of auditors

The predecessor should respond promptly and fully to the successor's reasonable inquiries. If, due to unusual circumstances, the predecessor decides to offer a limited response, this fact should be clearly stated. The successor should consider the implications of a limited response in deciding whether to accept the engagement.

SAS No. 84 also states that the successor should request the client to authorize the predecessor to allow a review of his or her working papers. (An illustrative client consent and acknowledgement letter documenting this authorization is included in SAS No. 84.) The successor's review of the predecessor's working papers may affect the nature, timing, and extent of the successor's procedures with respect to the opening balances and consistency of accounting principles. However, the work performed and the conclusions reached are solely the responsibility of the successor. The prede-

cessor should ordinarily permit the successor to review his or her working papers, but SAS No. 84 provides that the extent, if any, to which a predecessor permits access to the working papers is a matter of judgment.

SAS No. 84 also discusses audits of financial statements that have been previously audited, as well as providing communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor. Auditors who find themselves in the role of predecessor or successor auditors should refer to the full text of SAS No. 84 to determine the extent of their responsibilities under GAAS.

Executive Summary—A Change of Auditors

- SAS No. 84 provides guidance on communications between predecessor and successor auditors.
 - SAS No. 84 also addresses issues such as a review of predecessor working papers, previously audited financial statements, and discovery of misstatements by the successor, as well as providing illustrative letters for predecessor- or successor-related communications.
-

Impact of New Accounting Pronouncements

Investment companies will likely be implementing new financial accounting standards that could have a significant impact on their accounting procedures and financial statements, such as FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or FASB Statement No. 140, *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (see the related discussions in the “Accounting Issues and Developments” section of this Audit Risk Alert.) SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended, provides guidance on the independent auditor’s consideration of internal control in planning the audit of financial statements in accordance with GAAS, including a discussion of the entity’s risk assessment for financial reporting purposes. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity’s ability to record, process, summarize, and report financial

data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as, among other circumstances, the adoption of new accounting pronouncements or changing accounting principles. Auditors should obtain a sufficient knowledge of the client's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides how to address those risks, and be alert to the implications on the internal control of the client.

PITF Practice Alerts

The Professional Issues Task Force (PITF), established by the SEC Practice Section (SECPS) Executive Committee, formulates guidance based on issues arising in litigation, peer reviews, and firm inspections to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. These Practice Alerts—which are based on existing audit literature, the professional experience of the members of the PITF, and information provided by SECPS member firms—provide auditors with information that may help them improve the efficiency and effectiveness of their audits. The information contained in the Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA. As of the writing of this Audit Risk Alert, four new Practice Alerts were issued in 2000:

- Practice Alert No. 00-4, *Quarterly Review Procedures for Public Companies*
- Practice Alert No. 00-3, *Auditing Construction Contracts*
- Practice Alert No. 00-2, *Quality of Accounting Principles—Guidance for Discussion with Audit Committees*
- Practice Alert No. 00-1, *Accounting for Certain Equity Transactions*

Additional discussion and a listing of recently and previously issued Practice Alerts is available on the AICPA Web site at www.aicpa.org/members/div/secps/lit/practice.htm.

New Auditing and Attestation Pronouncements

What are the AICPA's new Statements on Auditing Standards, Statements on Standards for Attestation Engagements, and Audit Interpretations that auditors of investment companies should know about?

In this section, we present brief summaries of auditing pronouncements issued since the publication of last year's Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For a full listing and description of all new auditing and attestation standards, see the AICPA general *Audit Risk Alert 2000/01*. For information on auditing pronouncements issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

Auditing Standards

SAS No. 88, Service Organizations and Reporting on Consistency

In December 1999, the ASB issued SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU secs. 324 and 420). Part 1, "Service Organizations," amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.03 and 324.06-10) to—

- Clarify the applicability of SAS No. 70 by stating that the SAS is applicable if an entity obtains services from another organization that are part of the entity's information system. It also provides guidance on the types of services that would be considered part of an entity's information system.
- Revise and clarify the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls.
- Clarify the guidance on determining whether information about a service organization's controls is necessary to plan the audit.

-
-
- Clarify that information about a service organization's controls may be obtained from a variety of sources.
 - Change the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations* to *Service Organizations*.

Part 2, "Reporting on Consistency," amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles") to—

- Conform the list of changes that constitute a change in the reporting entity (AU sec. 420.07) to the guidance in paragraph 12 of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.
- Clarify that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event.
- Eliminate the requirement for a consistency explanatory paragraph in the auditor's report if a pooling of interests is not accounted for retroactively in comparative financial statements.
- Eliminate the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year.

All of the amendments contained in SAS No. 88 were effective upon issuance.

SAS No. 89, *Audit Adjustments*

In December 1999, the ASB issued SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. It also clarifies management's responsibility for the disposition of finan-

cial statement misstatements brought to its attention. SAS No. 89 amends SAS No. 83, *Establishing an Understanding With the Client*; SAS No. 85, *Management Representations*; and SAS No. 61, *Communication With Audit Committees*, as follows:

1. SAS No. 83 is amended to include, in the understanding with the client, management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

2. SAS No. 85 is amended to require that the management representation letter include an acknowledgment by management that it has considered the financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, and has concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. It also amends the illustrative management representation letter in paragraph 6 of appendix A to SAS No. 85.
3. SAS No. 61 is amended to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

These amendments are effective for audits of financial statements for periods beginning on or after December 15, 1999, with early adoption permitted.

SAS No. 90, *Audit Committee Communications*

SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722), issued by the ASB in December 1999, amends SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). SAS No. 90 was issued in response to recommendation numbers 8 and 10 of the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which suggest changes to GAAS.

Among other things, the amendment to SAS No. 61 requires an auditor to discuss with the audit committees of SEC clients certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. It also encourages a three-way discussion among the auditor, management, and the audit committee. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted.

The amendment to SAS No. 71 clarifies that the accountant should communicate to the audit committee or be satisfied, through discussions with the audit committee, that matters described in SAS No. 61 have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. This amendment also requires the accountant of an SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 prior to the filing of the Form 10-Q. This amendment is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

The ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 391), to assist auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. The guidance in SAS No. 92, which supersedes SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), applies to—

- *Derivative instruments*, as that term is defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
- Hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting.
- *Debt and equity securities*, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

A discussion of the matters addressed by SAS No. 92 is included in “Auditing Derivatives” in the “Audit Issues and Developments” section of this Alert.

SAS No. 93, *Omnibus Statement on Auditing Standards—2000*

Issued in October 2000, SAS No. 93, *Omnibus Statement on Auditing Standards*—

1. Withdraws SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622). The guidance in SAS No. 75 will be incorporated in Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, to consolidate the guidance on agreed-upon procedures engagements in professional standards. The

withdrawal of SAS No. 75 is concurrent with the effective date of SSAE No. 10, scheduled to be issued in January 2001. The guidance in SSAE No. 10 on agreed-upon procedures engagements is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001, with earlier application permitted.

2. Amends SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), to include an identification in the auditor's report of the country of origin of the accounting principles used to prepare the financial statements and the auditing standards that the auditor followed in performing the audit. This amendment withdraws Auditing Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53-.55). This amendment is effective for reports issued or reissued on or after June 30, 2001. Earlier application is permitted.
3. Amends SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), to clarify the definition of a predecessor auditor. This amendment is effective for audits of financial statements for periods ending on or after June 30, 2001. Earlier application is permitted.

Auditing Interpretations

Seven new Auditing Interpretations were issued during the past year:

1. Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19-.31)
2. Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on*

Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53–.55)¹⁸

3. Interpretation No. 7, “Management’s and Auditor’s Responsibilities With Regard to Related Party Disclosures Prefaced by Terminology Such As Management Believes That,” of SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9334.22–.23)
4. Interpretation No. 1, “The Meaning of the Term *Misstatement*” of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.01-.04)
5. Interpretation No. 2, “Evaluating Differences in Estimates” of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.05-.09)
6. Interpretation No. 3, “Quantitative Measures of Materiality in Evaluating Audit Findings” of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.10-.14)
7. Interpretation No. 4, “Considering the Qualitative Characteristics of Misstatements” of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15-.17)

Auditing Interpretations are issued by the Audit Issues Task Force (AITF) of the ASB to provide timely guidance on the application of auditing pronouncements. Interpretations are reviewed by the ASB but are not as authoritative as ASB pronouncements. Nevertheless, auditors may have to justify a departure from an Interpretation if the quality of their work is questioned.

Help Desk—The full text of recently issued Auditing Interpretations can be obtained on the AICPA Web site at www.aicpa.org/-members/div/auditstd/announce/index.htm.

18. Withdrawn by SAS No. 93. See the “Auditing Standards” in this section of this Alert for further information.

New Attestation Standard

SSAE No. 10, *Attestation Standards: Revision and Recodification*

The ASB expects to issue SSAE No. 10, *Attestation Standards: Revision and Recodification*, in January 2001. SSAE No. 10 does the following:

- Changes the title of AT section 101 to *Attest Engagements*.
- Changes the definition of an attest engagement into a statement of applicability of the standard, as follows:

This statement applies to engagements in which a certified public accountant in the practice of public accounting (hereinafter referred to as a *practitioner*) is engaged to issue or does issue an examination, a review or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

- Revises the third general standard to focus on the essential elements of criteria: the criteria must be suitable and must be available to users. The subject matter also must be capable of reasonably consistent evaluation against the criteria.
- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report.
- Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties.
- Supersedes SSAE Nos. 1 through 9.

The new standard also revises and renumbers the AT sections as follows:

	<i>New AT section</i>	<i>Existing AT section</i>
Attest Engagements	101	100
Agreed-Upon Procedures Engagements	201	600
Financial Forecasts and Projections	301	200
Reporting on Pro Forma Financial Information	401	300
Reporting on an Entity's Internal Control Over Financial Reporting	501	400
Compliance Attestation	601	500
Management's Discussion and Analysis	701	700

The new SSAE also eliminates the requirement in AT section 201, *Agreed-Upon Procedures Engagements*, for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*. That withdrawal is reflected in SAS No. 93, *Omnibus Statement on Auditing Standards—2000*.

SSAE No. 10 is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

Help Desk—Look for a new AICPA Practice Aid on how to understand and apply the provisions of SSAE No. 10. It is expected to become available during the first quarter of 2001.

Executive Summary—New Auditing and Attestation Pronouncements

- In December 1999, the ASB issued SAS No. 88, *Service Organizations and Reporting on Consistency*. Part 1, "Service Organizations," amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*. Part 2, "Reporting on Consistency," amends SAS No. 1, *Codification of Auditing Standards and Procedures*.
- In December 1999, the ASB issued SAS No. 89, *Audit Adjustments*, which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor.

-
-
- In December 1999, the ASB issued SAS No. 90, *Audit Committee Communications*. SAS No. 90 revises SAS No. 61, *Communication With Audit Committees*, and SAS No. 71, *Interim Financial Information*.
 - The ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, to assist auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities.
 - The ASB issued SAS No. 93, *Omnibus Statement on Auditing Standards—2000*.
 - SSAE No. 10 is expected to be issued in January 2001.
 - Seven new Auditing Interpretations have been issued during the past year.
-

Accounting Issues and Developments¹⁹

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

.....
What are the requirements of the new FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities?
.....

In September 2000, the FASB issued Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FASB Statement No. 140 replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions without reconsideration.

.....
¹⁹ Readers should refer to the full text of the accounting pronouncements and SEC releases that are discussed in this section of the Audit Risk Alert. Further information related to the Financial Accounting Standards Board (FASB) projects can be obtained from the FASB Web site at www.fasb.org. Further information related to SEC rules and releases can be obtained from the SEC Web site at www.sec.gov.

FASB Statement No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB Statement No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

FASB Statement No. 140 provides implementation guidance for assessing isolation of transferred assets, conditions that constrain a transferee, conditions for an entity to be a qualifying special purpose entity (SPE), accounting for transfers of partial interests, measurement of retained interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including dollar rolls, wash sales, loan syndications and participations, risk participations in bankers acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities. This Statement also provides guidance about whether a transferor has retained effective control over assets transferred to qualifying SPEs through removal-of-accounts provisions, liquidation provisions, or other arrangements.

In addition to replacing FASB Statement No. 125, FASB Statement No. 140 rescinds FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, and carries forward the actions taken by FASB Statement No. 125.

FASB Statement No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. FASB Statement No. 140 is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are

presented for comparative purposes. FASB Statement No. 140 is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

The FASB staff is preparing a new Special Report, *A Guide to Implementation of Statement No. 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities: Questions and Answers*, which will be an updated version of its earlier Special Report about FASB Statement No. 125, the third edition of which was published in July 1999.

Also, the FASB Web site at www.fasb.org has a cross-reference table that shows what has happened to each paragraph of FASB Statement No. 125.

Derivatives and Hedging Activities

What are some of the recent developments affecting the accounting for derivatives and hedging activities?

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133 also contains extensive disclosure requirements.

FASB Statement No. 133 was amended as a result of the issuance of FASB Statement Nos. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, and 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133*. Among other matters, FASB Statement No. 137, which became effective upon issuance in June 1999, defers the effective date of FASB Statement No. 133 to all fiscal quarters of fiscal years beginning after June 15, 2000. Among other matters, FASB Statement No. 138 amends the accounting and reporting standards of FASB Statement No. 133 for certain derivative instruments and certain hedging activities as follows:

- The normal purchases and normal sales exception in paragraph 10(b) may be applied to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market mechanism to facilitate net settlement.
- The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest rate risk, the risk of changes in the benchmark interest rate would be the hedged risk.
- Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, may be the hedged item in fair value hedges or cash flow hedges.
- Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

FASB Statement No. 138 also amends FASB Statement No. 133 for decisions made by the FASB relating to the Derivatives Implementation Group (DIG) process. Certain decisions arising from the DIG process that required specific amendments to

FASB Statement No. 133 are incorporated in FASB Statement No. 138.

The FASB released the publication *Accounting for Derivative Instruments and Hedging Activities*. This publication contains a version of FASB Statement No. 133 that incorporates the amendments contained in FASB Statement Nos. 137 and 138, and the full text of issues that have been discussed by the DIG and cleared by the FASB through September 25, 2000.

See the related discussion “Auditing Derivatives” in the “Audit Issues and Developments” section of this Audit Risk Alert.

Other New FASB Pronouncements

The FASB also issued the following pronouncements:

- FASB Statement No. 139, *Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121*. A summary is included in the AICPA general *Audit Risk Alert—2000/01*.
- FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an interpretation of APB Opinion No. 25. A summary is included in the AICPA general *Audit Risk Alert—2000/01*.
- The status of issues considered recently by the EITF of the FASB can be found in the AICPA general *Audit Risk Alert—2000/01* (EITF issues discussed through the September 2000 meeting).

Also, in February 2000, the FASB issued FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. Unlike a Statement of Financial Accounting Standards, FASB Concepts Statements do not establish GAAP. The purpose of the series of FASB Concepts Statements is to set forth fundamentals on which financial accounting and reporting standards will be based, and more specifically, to establish the objectives and concepts that the FASB will use in developing standards of financial accounting and reporting.

SEC Accounting Issues and Developments

What are some of the recent SEC accounting-related developments?

Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges*²⁰

In November 1999, the SEC staff released Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges.

Among other matters, SAB No. 100 reiterates existing criteria in EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and provides guidance on how the SEC staff interprets and applies the criteria in EITF Issue Nos. 94-3 and 95-3 and FASB Statement No. 121. Costs or charges falling within the scope of EITF Issue Nos. 94-3 and 95-3 or FASB Statement No. 121 should be accounted for in accordance with the appropriate standard. EITF Issue Nos. 94-3 and 95-3 and FASB Statement No. 121 should not be applied to events or circumstances falling outside of their respective scopes. SAB No. 100 states that depreciable lives, amortization periods, and salvage values of long-lived assets need to be reviewed and, where appropriate, changed on a timely basis.

SAB No. 100 also provides the SEC staff's views regarding—

- Assessing and measuring enterprise level goodwill for impairment in accordance with APB Opinion No. 17, *Intangible Assets*.
- The measurement of liabilities and other loss accruals assumed in a purchase combination.

20. Staff Accounting Bulletins (SABs) are not rules or interpretations of the SEC. SABs represent interpretations and practices followed by staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

SAB No. 101, *Revenue Recognition in Financial Statements*²¹

In December 1999, the SEC staff released SAB No. 101, *Revenue Recognition in Financial Statements*, which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB No. 101 does not change existing accounting guidance on revenue recognition. Rather, SAB No. 101 draws upon the existing rules and explains how the SEC staff applies those rules, by analogy, to other transactions that the existing rules do not specifically address, and spells out the basic criteria that must be met before registrants can record revenue. The implementation date of SAB No. 101 was delayed by SAB 101A, *Amendment: Revenue Recognition in Financial Statements*, and again by SAB No. 101B, *Second Amendment: Revenue Recognition in Financial Statements*. SAB 101B delays the implementation date of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999.

Help Desk—The full text of SAB Nos. 100 and 101 are available at the SEC Web site at www.sec.gov.

Since the issuance of SAB No. 101, the SEC staff has received inquiries from auditors, preparers, and analysts about how the guidance in accounting standards and SAB No. 101 would apply to particular transactions, and in response to those inquiries, has prepared *Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*.

Help Desk—*Staff Accounting Bulletin No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers* is available at the SEC Web site at www.sec.gov.

Executive Summary—Accounting Issues and Developments

- In September 2000, the FASB issued Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement No. 125.
- FASB Statement No. 133 was amended as a result of the issuance of FASB Statement Nos. 137, *Accounting for Derivative Instruments and*

.....
21. See footnote 20.

Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, and 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133. FASB Statement No. 137 defers the effective date of FASB Statement No. 133 to all fiscal quarters of fiscal years beginning after June 15, 2000.

- Other FASB issuances: FASB Statement No. 139, *Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121*; FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an interpretation of APB Opinion No. 25; and FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.
 - SEC SAB No. 100, *Restructuring and Impairment Charges*, provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges.
 - SEC SAB No. 101, *Revenue Recognition in Financial Statements*, provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC.
-

On the Horizon²²

FASB Exposure Drafts

What are some of the outstanding exposure drafts that have been issued by the FASB for comment?

Proposed Statement of Financial Accounting Standards on Consolidated Financial Statements

In February 1999, the FASB issued an exposure draft of a proposed FASB Statement, *Consolidated Financial Statements: Pur-*

22. This section briefly summarizes some of the exposure drafts that have been released by the FASB, the Accounting Standards Executive Committee (AcSEC), and the Auditing Standards Board (ASB) for comment and that were outstanding at the time of the writing of this Audit Risk Alert. They are nonauthoritative and cannot be used as a basis for changing generally accepted auditing standards or generally accepted accounting principles. Auditors should be alert for the issuance of final standards or other developments related to these and other FASB, AcSEC, and ASB projects. Further information related to the FASB projects can be obtained from the FASB Web site at www.fasb.org. Further information related to the AcSEC and ASB projects can be obtained from the AICPA Web site at www.aicpa.org.

pose and Policy, a revision to an exposure draft issued in October 1995. This proposed Statement would establish standards that specify when entities should be included in consolidated financial statements. The proposed statement would—

- Define *control* as the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others.
- Require that a controlling entity (parent) consolidate all entities that it controls (subsidiaries) unless control is temporary at the time the entity becomes a subsidiary.
- Preclude consolidation of a new subsidiary if a parent's control is temporary at the date that control is obtained.

The proposed Statement would supersede or amend various accounting pronouncements. It would apply to business enterprises and not-for-profit organizations that control other entities regardless of the legal form of the controlling and controlled entities. It would not apply to financial statements of reporting entities that in accordance with GAAP carry substantially all of their assets, including investments in controlled entities, at fair value with all changes in value reported in a statement of net income or financial performance, including mutual funds and other investment companies that apply the provisions of the AICPA Audit and Accounting Guide *Audits of Investment Companies* and report all changes in value in a statement of operations.

Proposed Statement of Financial Accounting Standards on Business Combinations and Intangible Assets

In September 1999, the FASB issued an exposure draft of a proposed FASB Statement, *Business Combinations and Intangible Assets*. This proposed Statement is divided into two parts. Part I addresses the method of accounting for business combinations. Part II would establish new accounting standards for both identifiable and unidentifiable intangible assets acquired (including

goodwill), whether acquired singularly, in a group, or as part of a business combination.

The proposed Statement would amend APB Opinion No. 16, *Business Combinations*, supersede APB Opinion No. 17, *Intangible Assets*, and amend or supersede other accounting pronouncements.

AcSEC Exposure Drafts

What are some of the outstanding exposure drafts relevant to investment companies that have been issued by AcSEC for comment?

Proposed SOP—*Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*

AcSEC issued an exposure draft of a proposed SOP, *Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools*. The proposed SOP would include investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974 in the scope of SOP 95-2.

ASB Exposure Drafts

What exposure draft has been issued by the ASB for comment?

Proposed SAS—*Amendment to Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit, as amended by SAS No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*

Issued in November 2000, this proposed statement on auditing standards amends SAS No. 55 to provide guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk. The ASB believes the guidance is needed because entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Conse-

quently, in some circumstances, auditors may need to perform tests of controls to perform effective audits.

Resource Central

What other AICPA publications, products, and services can be of value to auditors of investment companies?

Order Department (Member Satisfaction)

To order AICPA products, including AICPA products discussed in this Audit Risk Alert, call (888) 777-7077; write AICPA Order Department, CLA10, P.O. Box 2209, Jersey City, NJ 07303-2209; fax (800) 362-5066. For best results, call Monday through Friday between 8:30 a.m. and 7:30 p.m. EST. Obtaining product information and placing online orders can be done at the AICPA's Web site, www.aicpa.org.

Continuing Professional Education Courses

The AICPA offers many continuing professional education (CPE) courses, available for both group and self-study. Also, the AICPA has launched a new online learning tool, AICPA InfoBytes. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments.

Help Desk—For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org. You can register for AICPA InfoBytes at infobytes.aicpaservices.org.

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

The AICPA Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Technical Practice Aids

AICPA Technical Practice Aids includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. *Technical Practice Aids* is available both as a subscription service and in paperback form.

AICPA reSOURCE

The AICPA is currently offering a CD-ROM product titled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to the following AICPA professional literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products. To order any publications included on the CD-ROM, call (888) 777-7077.

Assurance Services Alerts

The Assurance Services Alert series provides practitioners with information about the emerging practice areas of *CPA ElderCare Services*, *WebTrustSM* and *CPA SysTrustSM*. These Assurance Services Alerts provide both an introduction to those who are unfamiliar with assurance services and an update of important new developments for those who have expanded their practice to include these assurance services. The 2000 Assurance Services Alerts are available from the AICPA for the following services:

- *WebTrustSM—2000* (Product No. 022249kk)

-
-
- *CPA ElderCare Services—2000* (Product No. 022248kk)
 - *CPA SysTrustSM—2000* (Product No. 022253kk)

References for Additional Guidance

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert—2000/01* (Product No. 022260kk). The new AICPA Audit Risk Alert—*SEC Alert* (Product No. 022272kk) provides valuable insights into SEC staff perspectives on important accounting and auditing matters, along with updates on recent SEC activities. The new AICPA Audit Risk Alert *The ABCs of Independence* (Product No. 022271kk) is a must-read basic primer on the fundamentals of independence.

These Alerts may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077 or faxing a request to (800) 362-5066. Additional product information is available on the AICPA's Web site at www.aicpa.org.

.....

This Audit Risk Alert replaces *Investment Companies Industry Developments—1999/2000*. The *Investment Companies Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would be appreciated. You may email these comments to mkasica@aicpa.org or write to:

Maryann Kasica, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

APPENDIX A

***Federal Regulations Related to
Money Laundering***

The Bank Secrecy Act (BSA), enacted to address the problems of money laundering and other financial crime, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe criminal and civil penalties. Investment companies are defined as financial institutions under the Act (Title 31 USC 5312 (a) (I)), and unless they are subsidiaries of bank holding companies, they are not currently required to report suspicious activity either by employees or by customers, to the Treasury Department. The Treasury Department encourages all bank and non-bank financial institutions to voluntarily report regarding suspicions of money laundering and related financial crime, as appropriate. Subsidiaries of bank holding companies are required to report suspicious activity by the Federal Reserve (12 CFR 225). The Annunzio-Wylie Anti-Money Laundering Act of 1992 provides a safe harbor from civil liability for reporting financial institutions.

Internal Revenue Service regulations require investment companies to file reports for cash transactions greater than \$10,000 (26 USC 60501).¹ BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs—Customs Form 4790) and foreign bank and financial accounts (FBARs—Treasury Form TDF 90-22.1) have not been modified since 1989 and 1987, respectively. However, on January 16, 1997,

.....
1. However, responsibility to report may lie with the investment company's transfer agent or selling broker-dealer/underwriter in connection with reportable payments.

(see *Federal Register*) Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts (see *Federal Register* for that date).

On July 13, 1998 the European Union proposed expanding the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This proposal, if implemented as proposed, would apply to the audits of European operations and subsidiaries of U.S. investment companies.

The International Organization of Securities Commissions (IOSCO) in its "Objectives and Principles of Securities Regulation" obliges member states (Principle 8.5) to require securities firms to "have in place policies and procedures" to reduce the likelihood of money laundering.

According to the National Association of Attorneys General, thirty-three states, the District of Columbia, and Puerto Rico have imposed criminal penalties for money laundering offenses.

For copies of BSA forms mentioned here and more information regarding anti-money laundering issues as they affect investment companies, consult the FinCEN Internet site at www.treas.gov/fincen.

AICPA Industry Expert Panel Created

The AICPA has developed an expert panel that focuses on identifying business reporting issues, with an emphasis on audit and accounting matters, in the financial services industry. The Financial Services Expert Panel is one of a number of industry-specific panels that have been created as part of the AICPA's effort to revamp the Institute's volunteer structure.

The Expert Panel will identify and discuss industry-specific emerging issues and their effect on CPAs, identify additional guidance, if any (both traditional and nontraditional), that members need to be effective and to protect the public, and develop plans for providing input on initiatives that should be brought to the attention of standards setters or the AICPA prioritization mechanism, and other matters.

Joining the Expert Panel

Expert Panel members should be forward-thinking, vision-aligned, cross-functional individuals. In addition, Panel members may be non-CPA business professionals. *Cross-functional* is intended to include members with expertise in the traditional areas of accounting and auditing, as well as awareness and, perhaps, expertise beyond the traditional areas. For example, depending on the needs of the area covered by the Expert Panel, the members might have expertise in assurance services, operational and management issues, technology, corporate governance, legislation, and other areas, in addition to expertise in the traditional areas of accounting and auditing.

Rewards of Joining the Panel

Serving on the Panel is a rewarding and enriching experience. Panel members interact with other top professionals in their industry and address and resolve key forces, issues, and trends shaping the financial services world. Moreover, Expert Panel members take the knowledge and experience they gain on the Panel with them, enriching themselves, their work, and their firms.

Panel members will serve one-year terms, generally for three consecutive years. For more information on the Expert Panels or to apply, visit AICPA Volunteer Central at www.skillscape.com/aicpaonline.

Investment Company Regulatory Task Force

The AICPA also has established the Investment Company Regulatory Task Force to liaise with regulatory agencies to advocate the profession's views and to provide technical counsel to ensure that related regulatory, or broad private-sector requirements involving accounting, auditing, or work by CPAs for the investment companies industry are consistent with and workable under professional standards set in the private sector.

Information Sources

<i>Organization</i>	<i>Web site, Address, Telephone</i>
American Institute of Certified Public Accountants	www.aicpa.org Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077
Financial Accounting Standards Board	www.fasb.org Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (800) 748-0659
Financial Crimes Enforcement Network (FinCEN)	www.treas.gov/fincen
Independence Standards Board	www.cpaindependence.org 1211 Avenue of the Americas, 6 th Floor New York, NY 10036 Telephone: (212) 596-6133
U.S. Securities and Exchange Commission Publications Unit:	www.sec.gov 450 Fifth Street, NW Washington, DC 20549-0011 Telephone: (202) 942-4040 SEC Public Reference Room: Telephone: (202) 942-8090 (202) 942-8092 (tty)
Investment Company Institute	www.ici.org 1401 H Street NW Washington, DC 20005 General Information: Telephone: (202) 326-5800

